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STATE - PLEASE PASS DOE FOR RUSSELL ROTH
STATE - PLEASE PASS TO DOC FOR LORRIE FUSSELL
STATE - PLEASE PASS TO USTR FOR KATE KALUTKIEWICZ.
WHA/EPSC
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AMEMBASSY BRASILIA PASS TO AMCONSUL RECIFE

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SUBJECT: CAN THE OIL INDUSTRY BEAT BACK THE PRE-SALT LAW?

REF: BRASILIA 1099; RIO DE JANEIRO 294; RIO DE JANEIRO 288

CLASSIFIED BY: Dennis W. Hearne, Principal Officer; REASON: 1.4(B),
(D)

SUMMARY

¶1. (C) Although major international and independent oil companies continue to view the regulatory framework to develop Brazil's offshore Pre-salt oil and gas reserves as potentially debilitating to their future exploration and production (E&P) operations here, the Rio de Janeiro-based industry group that represents these companies has thus far been unsuccessful in efforts to enact changes to the law in the House of Deputies. Industry continues to argue that the most detrimental aspect of the framework on the commercial viability of future Pre-salt operations, and even local manufacturing, is Petrobras' designation as chief operator, part of the bill addressing PSAs. Local manufacturers and suppliers also will also be affected, but the largest Brazilian petroleum suppliers group complained the political nature of the framework was impeding their voice on the matter in Congress. With industry resigned to the passage of the framework's four bills in the House of Deputies (for the most part in current forms), its strategy going forward is to enlist new partners to focus on the Senate, with the goals of winning key amendments to the bills, as well as pushing a vote back until after the October Presidential and Congressional elections. End Summary.

ELECTION YEAR MAKING FOR A "HARD BATTLE" FOR INDUSTRY

¶2. (C) Although major international and independent oil companies (IOCs) continue to view the regulatory framework to develop Brazil's offshore Pre-salt oil and gas reserves as potentially debilitating to their future exploration and production (E&P) operations here, the Rio de Janeiro-based industry group that represents these companies has thus far been unsuccessful in efforts to enact changes to the law in the House of Deputies. Patricia Pradal, head of government relations for Chevron told Econoff on November 19 that since President Lula announced the framework on August 31, industry had been fighting a "hard battle" to enact changes to the legislation, but the House of Deputies has not taken any industry concerns into consideration. (Note: Pradal also heads the steering committee of the Brazilian Institute for Petroleum (IBP), the industry umbrella group that represents all

major international and independent oil companies operating in Brazil, including Petrobras. She spoke to Econoff in this capacity. End Note). Pradal lamented the lack of support from opposition parties in Congress, blaming Presidential and Congressional elections next year and explaining, "The PSDB [primary opposition party] simply has not shown up to this debate." She expressed begrudging respect to President Lula's International Relations Adviser Marco Aurelio Garcia and Press Secretary Franklin Martins as the principal orchestrators of the Government's strategy, stating, "They are the professionals, and we are the amateurs."

PSDB'S SERRA REPORTEDLY OPPOSES FRAMEWORK, BUT NO SENSE OF URGENCY

13. (C) According to IBP's Pradal, likely PSDB 2010 Presidential Candidate Jose Serra opposed the framework, but seemed to lack a sense of urgency on the issue. She quoted him as telling industry representatives, "Let those guys [Worker's Party] do what they want. There will be no bid rounds, and then we will show everyone that the old model worked...And we will change it back." As for what would happen to foreign oil companies in the meantime, Serra reportedly remarked, "You will come and go." Congressional sources have also told Embassy officers that Serra has signaled PSDB and other opposition sources that they should amend - but not oppose the final Pre-Salt legislation, and urged opposition legislators to avoid vocal opposition to the law.

CURRENT STATUS OF THE FRAMEWORK

14. (U) On August 31, President Lula announced the framework and sent it to Congress for approval. On November 18, the House of Deputies (Camara) passed the first of the four bills (reftel A) that make up the framework, by a vote of 250 to 67, to create Petrosal, a new government entity that will represent the Brazilian government in the not-yet-approved production sharing regime. Further reporting will be reported septel. (Note: The next bill to likely go to vote in the House of Deputies will be the creation of a social fund, followed by the 50 billion USD Petrobras capitalization bill. We anticipate the bill instituting Production Sharing Agreements (PSA) - and making Petrobras the chief operator of all Pre-salt blocks - will be the last to go before a House of Deputies vote. Once the House of Deputies passes a bill, it must then go before the Senate for approval. If the Senate passes the bill, it is final. If it amends the Q11, it will then go back to the House of Deputies for discussion and revote. Post will report further on legislative developments septel. End Note).

PETROSAL: ALL THE CONTROL, NONE OF THE LIABILITY?

15. (C) While not opposed per se to the existence of Petrosal, industry is concerned this group of political appointees, who will administer the Pre-salt blocks on behalf of the Brazilian government, will also wield disproportionate power over the operations of any Production Sharing consortium into which an oil company enters. Under the law as proposed, Petrosal controls 50 percent of the seats - with veto power - in a PSA consortia's operating committee. According to IBP's Pradal, this will therefore give Petrosal significant power over key E&P decisions, such as budget, environmental, and safety matters, in the Pre-salt blocks. "They will have all the control, and none of the liability," she said.

PETROBRAS AS CHIEF OPERATOR UNIVERSALLY CRITICIZED

¶6. (C) Industry continues to argue the most detrimental aspect of the framework on the commercial viability of future Pre-salt operations is Petrobras' designation as chief operator, part of the bill addressing PSAs. Emphasizing a point she made to the Charge d'Affaires on September 1 (reftel B), Exxon's Lacerda said having Petrobras run all Pre-salt blocks will effectively relegate oil companies to mere financing bodies. Robert Abib of Anadarko said on November 19 that Petrobras' role as chief operator could shut out the smaller independent oil companies if the parastatal focuses on the Pre-salt's largest fields, rather than smaller ones where independents normally specialize and focus their operations. Exxon's Lacerda complained the PSA bill failed to sufficiently define the fiscal terms assigned to the contracts, and said under the proposed regime, such terms would only become clear immediately prior to a bid round, making it nearly impossible for a company to effectively prepare. Both IBP's Pradal and Lacerda said ongoing debate on the distribution of royalties to oil producing and non-producing states, municipalities, and the federal government, which is also part of the PSA bill, was preventing any real discussion on the framework's transparency and ability to attract investment.

¶7. (C) Should Petrobras' chief operator designation remain, IBP's Pradal said it would be impossible to compete in bid rounds against National Oil Companies (NOC), such as China's Sinopec and Russia's Gazprom. According to Pradal, it will come down to who gives the government the most profit. "The Chinese can outbid everybody,"

she explained. "They can break-even and it will still be attractive to them. They just want the oil." Pradal said Chevron would not even bid under such circumstances. (Note: Foreshadowing greater NOC involvement in Brazil, Colombia's 90 percent state-owned oil company Ecopetrol opened an office in Rio de Janeiro on November

¶18. Furthermore, Petrobras CFO Barbassa said on November 23 that the parastatal would be sending top executives to China in early 2010, in an effort to attract Chinese petroleum equipment suppliers to Brazil. Post will report on both issues septel. End Note).

WHAT ABOUT THE LOCAL MANUFACTURERS?

¶8. (C) Brazilian manufacturers and suppliers also stand to lose from Petrobras' role as chief operator, but Brazil's largest petroleum suppliers group complained the political nature of the framework was impeding their voice on the matter in Congress. Exxon's Lacerda said local manufacturers and suppliers would stand to lose by having only one principal client, suggesting the National Organization for the Petroleum Industry (ONIP), a nonprofit forum that brings together Brazil's largest petroleum service providers and suppliers, could be a powerful ally in this fight. She complained, however, that ONIP had thus far been "quiet" on the issue. ONIP Director Alfredo Renault told Econoff on November 23 that while ONIP does not engage on public policy or lobbying, it was concerned about Petrobras' designation of chief operator in the framework, and expressed these worries to Congress. Unfortunately, he explained, the Special Committee in the House of Deputies where Renault made his presentation was driven by "politics rather than logic," and appeared indifferent to his concerns. According to Renault, having only one client would not benefit Brazilian manufacturers' competitiveness nor provide them with the opportunity to establish the buyer-supplier relationships with major international and independent oil companies, crucial to doing business overseas. Renault stated some industry associations within ONIP favored the framework, but said these groups tended to include companies that already have extensive commercial relationships with Petrobras.

RISKY PETROBRAS CAPITALIZATION

¶9. (C) Oil company representatives see legal problems with the bill concerning the capitalization of Petrobras through a guarantee of 5 billion barrels of Pre-salt oil, and question the constitutionality of the transaction. IBP's Pradal explained the proposed capitalization, which will infuse Petrobras with promised reserves in exchange for increased government shares in the company, has precedent in other countries; she said, however, such precedent involved proven reserves, rather than unproven ones, as they are in this case (Note: Pradal was unable to name the country where this occurred, but stated Chevron's legal team was researching the precedent. End Note). Anadarko's Abib emphasized the risk of diluting Petrobras' shareholder value, and said the company was risking a breach of its fiduciary responsibilities. Claiming it was impossible to accurately value the Pre-Salt oil, he claimed Petrobras shareholders could sue the company, if it turns out the reserves were over-valued. According to Pradal, accounting firms and investment banks held serious concerns over the transaction, but only one group of minority shareholders was vocally expressing these worries. She expressed consternation that the CVM had not even opened an investigation into the transaction. (Note: CVM is the Brazilian equivalent of the SEC. End Note). Pradal added, "As a matter of fact, we do not believe Petrobras is doing things by the books," claiming Petrobras willfully overestimated the 5-8 billion barrels of oil deposits in the Tupi offshore area. (Note: Petrobras is currently under Congressional investigation for fraudulent practices - tax evasion, overpaying for goods, and favorable donations to Lula supporters - but is widely expected to be cleared of charges by a Senate committee controlled by the governing coalition. End Note).

INTERNAL CONFLICT IN PETROBRAS?

¶10. (C) Petroleum industry players in Rio claim there is a division of opinion within Petrobras over the framework, and how it will end up affecting both Petrobras and the Pre-salt's overall development. Industry insiders claim some key Petrobras personnel oppose the shift to PSAs and the chief operator role, while Petrobras' upper management mostly favors the framework, viewing the Pre-salt reserves in zero-sum, nationalistic terms. For example, at a November 23 conference in Rio de Janeiro, Petrobras CFO Almir Barbassa expressed concern over whether Petrobras had the capacity to meet even its current commitments. "The pace of growth of new projects continues to increase, and I always wonder how much longer we will be able to grow at this pace," he said. "Projects abound, but we are constrained by a lack of available personnel, material, and equipment." Fernando Jose Cunha, General Director for Petrobras for Africa, Asia, and Euroasia told Econoff in August that the chief operator provision, along with the 30 percent mandatory share in every block, would "chase investors away" (reftel C). On the other hand, Exxon's Lacerda said Petrobras E&P Director Guilherme Estrella was largely responsible for the PSA bill's terms that prejudice international oil companies. (Note: Estrella has publicly compared Petrobras to a national space program, in terms of nationalist ambition, and is considered close to President Lula. End Note).

INDUSTRY STRATEGY: WHAT NOW?

¶11. (C) With industry resigned to the passage of the framework's four bills in the House of Deputies (for the most part in current forms), its strategy going forward is to focus on the Senate, which has a greater number of opposition legislators than the House of Deputies. Pradal said IBP would seek to enlist new partners to focus efforts, such as Brazilian independent E&P company OGX, the Federation of Industries of Sao Paulo State (FIESP), the Confederation of National Industries (CNI), and various Chambers of Commerce, in order to win Senate amendments concerning the Petrobras chief operator role and Petrosal terms. She also said it would be ideal to prevent a Senate vote before May, which could then push a vote back until after the October Presidential and Congressional elections. According to Pradal, the "real fight" would take place in February, after Congress returns from Recess.

Exxon's Lacerda also stated industry planned to make a "full court press" in the Senate, but, not leaving anything to chance, Exxon would now also branch out on its own to conduct lobbying efforts. Pradal emphasized both IBP and Chevron's hopes that Ambassador-designate Shannon could make a significant impact in this debate, and asked Econoff on multiple occasions when Congressional confirmation was expected.

COMMENT

¶12. (C) As they increase their efforts within this highly nationalistic debate, the IOCs will have to tread cautiously. Numerous Congressional contacts have shared their assessments with Post that, by becoming more vocal on the subject, the IOCs risk galvanizing nationalistic sentiment around the issue and damaging, rather than helping, their cause. At the same time, the IOCs are not optimistic over their ability to force key amendments to the current framework. Furthermore, even if the IOCs succeed in at least forcing a delay of a Senate vote until after a possible - but uncertain - victory of an opposition President, there is a sense that the wait to bid on commercially attractive opportunities in the Pre-salt will be long. Such outlooks, as well as the limited attractiveness of onshore blocks and the uncertainty of non-Pre-salt offshore frontier acreage, impede the IOCs' ability to effectively map out their local operations, and threaten their overall interest in Brazil. End Comment.

¶13. (U) This cable has been coordinated with Embassy Brasilia.
HEARNE